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INFORMATION CIRCULAR

To: Members of the staff

From: The Under-Secretary-General for Administration and Management

Subject: SIGNIFICANT CHANGES IN UNITED STATES ESTATE TAX AND THEIR POSSIBLE EFFECT ON NON-UNITED STATES CITIZEN STAFF MEMBERS*

1. The purpose of the present circular is to inform interested staff members about significant changes in the United States estate tax law and their possible effect on staff members and/or their surviving spouses and families.

2. The changes in the estate tax law are summarized in the annex to document DPA/MGR-4/89 issued to its staff by the administration of the Inter-American Development Bank (IDB), which is located at Washington. The annex was prepared with the assistance of expert tax counsel retained by IDB and has been annexed to the present circular with the permission of IDB.

3. It should be emphasized and clearly understood that neither IDB nor the United Nations is in a position to guarantee the complete accuracy of the information contained in the annex, which information is intended merely to alert possibly affected staff members to the changes in United States legislation.

4. Staff members should note that no specific course of action is recommended to be taken except that staff members who believe they have sufficient assets to be affected by the changes should seek the advice of a reputable professional accountant or attorney specializing in United States estate tax matters. Neither the Office of Human Resources Management nor the Office of Legal Affairs have specialist staff qualified in United States estate tax law who could advise staff members on their particular situation with regard to these estate tax law matters.

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* Personnel Manual index No. 13075.

Annex

Annex to IDB document DPA/MGR-4/89

(References to IDB employees, IDB staff retirement plan, etc., may be understood as referring to United Nations staff members, the United Nations Joint Staff Pension Fund, etc.)

This document presents a summary of the implications for expatriate staff members of the new United States federal estate tax.

I. ELIMINATION OF MARITAL DEDUCTION IF THE SURVIVING SPOUSE IS NOT A UNITED STATES CITIZEN

Under provisions of the Technical and Miscellaneous Revenue Act of 1988 (which are effective for estates of individuals who die after 10 November 1988) the marital deduction (assets transferred to a surviving spouse without dollar limitation) is no longer available if the surviving spouse is not a citizen of the United States. Thus, for the first time, persons in the United States with an intent to remain indefinitely are no longer subject to United States estate taxation on a basis identical with that applicable to United States citizens. It may be of some interest that this legislation was based upon the concern that substantial amounts of assets were being transferred free of United States estate taxation to surviving spouses who were not citizens of the United States. These spouses who were not United States citizens were perceived as being able permanently to avoid the incidence of United States estate taxation by terminating their United States resident status and transferring their property outside the United States.

II. UNITED STATES ESTATE TAXATION: OVERVIEW

A. United States citizens/United States residents

A deceased individual's estate is subject to United States estate taxation on world-wide assets if the deceased was a United States citizen or a United States resident. The definition of residency for United States estate tax purposes is quite different from that used for income tax purposes. Individuals who hold a G-4 visa are not United States residents for purposes of United States income taxes. (An exception to this rule exists for individuals holding a G-4 visa who elect to file a joint United States tax return with a spouse who is a resident or a citizen of the United States.) However, a person is a resident of the United States for estate tax purposes if the person lives in the United States with the intent to remain in the United States indefinitely. It is impossible to make definitive generalities but, the majority of IDB employees who have permanent positions with the IDB in Washington, D.C. would be regarded as United States residents for purposes of United States estate taxation.

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B. Non-residents

United States estate taxation of individuals who do not meet the tests of domicile discussed above may still be subjected to United States estate taxation on certain assets located in the United States. See section VII below.

C. Assets subject to estate taxation

For individuals who are citizens of the United States or United States domiciliaries (see sect. II A above), the taxable estate includes the value of all assets owned world wide less any legally enforceable debts or obligations. Although a detailed discussion of this concept is beyond the scope of this summary it is important to note that the gross estate of an IDB employee would include the value of group life insurance as well as the value of survivor benefits payable by the IDB staff retirement plan. Because of the inclusion of these assets in an IDB employee's taxable estate, it would appear that the estates of IDB employees will frequently have a value greater than $600,000, at which point they may be subject to United States estate taxation.

D. Joint ownership

Married people often own their home, bank accounts and other investments jointly with their spouse. In the event of the death of one spouse, for purposes of United States estate taxation, such jointly owned assets have been treated as if owned one half by each spouse. The 1988 tax legislation modified this rule if the surviving spouse is not a United States citizen. In such cases all jointly owned assets are treated as if completely owned by the deceased except to the extent it can be proven that the surviving spouse contributed (through earnings, inheritance, etc.) to the acquisition of the jointly held asset. The application of this rule can be quite onerous particularly when combined with the rule that property passing to a surviving spouse who is not a United States citizen is ineligible for the marital deduction.

E. Application of the above rules to employees of IDB

An example of how these rules operate is reflected in enclosed example 1. Estates of United States citizens or United States residents must exceed $600,000 before any United States estate tax liability results. None the less, because assets such as life insurance proceeds and the present actuarial value of survivor retirement benefits are included in the estate and because special rules exist for jointly owned property, employees should review their personal situation carefully before concluding that the United States estate tax could never apply to their personal estate.

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III. STEPS AVAILABLE TO MINIMIZE OR TO NEGATE THE POTENTIALLY ADVERSE CONSEQUENCES REFLECTED IN EXAMPLE 1

Example 1 demonstrates a result that in the case of a surviving spouse who is not a United States citizen is more than a mere inconvenience. In the hypothetical situation, the $153,000 estate tax would deplete all cash reserves. We believe several approaches discussed below exist which could be used to defer, to reduce or to eliminate the estate tax liability.

A. Establish a qualified domestic trust to hold assets on behalf of the surviving spouse

Although the 1988 Revenue Act eliminated the estate tax marital deduction for transfers to spouses who were not citizens of the United States, it provided a mechanism under which a beneficial interest in property - but not outright ownership - could be transferred to such spouses free of current estate taxation. Under this mechanism, which is called a qualified domestic trust, the estate tax which would have arisen if ownership to the property had been transferred outright to the surviving spouse is deferred so long as the property is held by the trust. Although the trust would be the legal owner of the asset, the absolute right to use the property (in the case of a residence or personal property) or the absolute right to receive income from the property (in the case of investment property) would rest with the surviving spouse. A number of controls are placed on a qualified domestic trust which provide comfort to the United States taxing authorities that any United States estate tax deferred by the use of the trust will be paid at the date of the surviving spouse's death or, if earlier, at the time of any transfer of ownership of the property from the trust. For individuals unfamiliar with the United States legal status of trusts, the concept of having ownership (or partial ownership) of the family home or family investments in such an entity is perplexing. But, as example 2 illustrates, the inconvenience of such an arrangement may be justified as an alternative to a significant estate tax payable from the estate of the first spouse to die.

B. Lifetime gifts to spouse

The principal problem reflected in example 1 is that the joint ownership rules as they apply when the surviving spouse is not a United States citizen may cause all family assets to be includable in the husband's estate. This problem can be overcome by terminating the joint ownership and making the spouse the sole owner of such property. For example, if $300,000 of the assets in example 1 are joint bank accounts, by transferring such bank accounts to the sole ownership of the spouse the taxable estate of the husband would be reduced (see example 3). Lifetime gifts to a spouse represent an easy and direct way to equalize the estates of husband and wife. Such transactions, however, may have significant non-tax considerations in the event of divorce. Furthermore, because of the limitations on allowable lifetime gifts to a spouse who is not a United States citizen (discussed in

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more detail in sect. VI), amounts transferred normally should be limited to $100,000 per year.

C. Transfer ownership of life insurance policy to spouse

United States estate tax laws include in the estate of the deceased the value of life insurance proceeds which are payable to the deceased's estate or to any other beneficiary if, at the time of death, the deceased possessed the power to change beneficiaries or certain other incidents of ownership. In the absence of careful planning, the application of these rules often will cause insurance proceeds to be included in the estate of the insured. Many insurance policies permit the insured irrevocably to assign ownership of such policies. Such assignments normally are effective for estate tax purposes only after a three-year period. Example 3 demonstrates the potential estate tax savings produced by this technique.

D. Establish a comprehensive estate tax plan that includes lifetime gifts, the use of a qualified domestic trust and the assignment of ownership of life insurance

To this point, all examples have focused on the objective of minimizing the estate tax payable upon the death of the first spouse to die. This is a good starting-point in estate planning. However, a comprehensive plan also considers the projected estate tax payable by the surviving spouse. Example 3 reflects a plan under which no estate tax would be due upon the death of the husband but $37,000 would be due from the estate of the surviving spouse. In such circumstances, a more comprehensive plan should be considered. (See example 4, which reflects a plan which would completely eliminate present and future United States estate taxation.)

E. Utilize the credit for estate taxes paid by first spouse's estate

The 1988 legislation anticipated situations in which property subject to estate tax upon the death of the first spouse (due to the absence of the marital deduction) could also be subjected to estate tax in the surviving spouse's estate. To provide relief from this double taxation, which does not occur if the surviving spouse is a United States citizen, an estate tax credit was provided. This credit reduces the estate tax payable by the estate of the surviving spouse to the extent assets are included which were subjected to estate taxation in the first spouse's estate. The economic effect of this provision depends upon a number of variables. However, in many situations the effect will be to cause the combined estate tax liability in situations involving surviving spouses who are not United States citizens to be identical with that applicable if the surviving spouse is a United States citizen. Thus the magnitude if not the timing of estate taxation will be equalized.

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IV. POSSIBLE LEGISLATIVE RELIEF

There have been numerous suggestions for legislative relief. Some of the proposed changes are contained as Technical Corrections to the 1988 Act, which were approved by the House Ways and Means Committee on 14 September 1989 and by the Senate Finance Committee on 10 October 1989. Independent of these technical corrections proposals, IDB along with the World Bank and the International Monetary Fund (IMF) have initiated the process of attempting to secure more substantive relief applicable to employees of international organizations. It must be emphasized that the legislative proposals under immediate consideration are more procedural than substantive and would streamline the process of creating qualified domestic trusts but would not restore an unlimited marital deduction to situations involving surviving spouses who are not citizens of the United States. Even if more substantive legislative relief is ultimately secured, it is extremely unlikely that such relief would be retroactive. For these reasons we believe employees of IDB who may be adversely affected by the existing estate tax laws would be ill-advised to ignore the problem under the assumption that remedial legislation is inevitable.

V. UNITED STATES ESTATE TAX PLANNING IF THE SURVIVING SPOUSE IS A UNITED STATES CITIZEN

The scope of this memorandum is limited to the specific situation in which the surviving spouse is not a United States citizen. It should be emphasized, however, that the availability of an unlimited marital deduction if the surviving spouse is a United States citizen (see example 1) does not eliminate the need for estate tax planning. In such circumstances the marital deduction may provide only temporary relief from estate taxation and in the absence of some planning the estate of the surviving spouse may be confronted with a substantial estate tax problem.

VI. UNITED STATES GIFT TAXATION OF TRANSFERS TO A SPOUSE WHO IS NOT A UNITED STATES CITIZEN

The United States system of estate taxation is complemented by a system of gift taxation. In effect, free of gift or estate taxation a United States citizen or an individual domiciled in the United States may transfer during lifetime or at death assets with a value up to $600,000. There is no limitation on lifetime transfers to a spouse who is a United States citizen. However, the 1988 tax legislation revised this rule as applied to transfers to a spouse who is not a United States citizen. Such transfers are exempted from United States gift taxation only in amounts up to $100,000 annually. This is a substantial amount which ordinarily would not excessively inhibit transfers to a spouse who is not a United States citizen. Care should be taken in transactions such as terminating joint ownership (see example 3) so that amounts transferred to a spouse who is not a United States citizen are limited to $100,000 a year.

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VII. SUBSTANTIAL INCREASE IN UNITED STATES ESTATE TAX RATES APPLICABLE TO ESTATES OF NON-RESIDENTS

As discussed above in section II A, it appears that most employees of IDB who hold permanent positions in Washington would be subject to United States estate taxation as residents. The United States estate taxation of such individuals is discussed in detail above. There are, however, employees of IDB whose positions in Washington are not permanent, consultants, and other employees whose personal circumstances indicate no fixed intention to remain in the United States who are likely to be subjected to United States estate taxation as non-residents. A detailed discussion of the United States estate taxation of non-residents is beyond the scope of this memorandum. However, the 1988 Tax Act substantially increased United States estate tax rates applicable to non-resident estates (see exhibit II). The United States estate tax applies only to assets held by non-residents which are located in the United States. In applying these situs rules, bank accounts in the United States and United States life insurance policies are specifically excluded from United States taxation but it appears survivor benefits payable by the IDB retirement plan would be treated as an asset in the United States.

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Example 1

RESTRICTIONS ON MARITAL DEDUCTION AND TREATMENT OF JOINTLY OWNED PROPERTY IF SURVIVING SPOUSE IS NOT A UNITED STATES CITIZEN

Assumptions

1. An employee of IDB in Washington for 20 years under a G-4 visa dies.

2. The surviving spouse has never worked.

3. Family assets consist of the following:

		$	$
(a)	Jointly owned home:		
	Market value	400 000	
	Outstanding mortgage	(100 000)	300 000
(b)	Accrued IDB retirement benefits payable to surviving spouse		300 000
(c)	Life insurance benefits payable to surviving spouse		100 000
(d)	Other jointly owned investments and personal property		300 000
	Total		1 000 000

4. As a result of joint ownership, provisions in insurance policies or retirement plans, and the husband's will, all property is transferred to the surviving spouse upon his death.

5. See below for the calculation of the resulting United States estate tax liability depending upon United States citizenship status of the surviving spouse.

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	Spouse is a United States citizen $	Spouse is not a United States citizen $
Employee's estate		
1. Family home	150 000 a/	300 000 b/
2. Retirement benefits	300 000	300 000
3. Insurance	100 000	100 000
4. Other property	150 000 a/	300 000 b/
Gross estate	700 000	1 000 000
Marital deduction	(700 000) c/	N/A d/
Taxable estate	0	1 000 000
Estate tax liability	0	153 000

a/ Assets owned jointly with a surviving spouse who is a United States citizen are treated as if owned half by each.

b/ Assets owned jointly with a surviving spouse who is not a United States citizen are treated as if owned completely by the deceased except to the extent it is established that the surviving spouse provided financial consideration in acquiring the asset.

c/ There is an unlimited marital deduction for property transferred to a surviving spouse who is a United States citizen.

d/ No marital deduction is permitted for property which is transferred to a surviving spouse who is not a United States citizen.

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Example 2

USE OF A QUALIFIED DOMESTIC TRUST

Assumptions

Same as example 1 except a qualified domestic trust is created and title to the family residence is transferred to the trust upon the death of the employee.

	Spouse is not a United States citizen $
Employee's estate	
1. Family home	300 000
2. Retirement benefits	300 000
3. Insurance	100 000
4. Other property	300 000
Gross estate	1 000 000 a/
Marital deduction	N/A
Assets placed in qualifying domestic trust	300 000
Taxable estate	700 000
Estate tax liability	
1. Currently payable	37 000
2. Payable at date of death of surviving spouse	116 000
Total estate tax	153 000

a/ Same as example 1.

Example 3

USE OF LIFETIME GIFTS TO TRANSFER OWNERSHIP OF JOINT ASSETS AND LIFE INSURANCE POLICY TO SPOUSE

Assumptions

Same as example 1 except the ownership of the $300,000 of other property and the ownership of the life insurance policy is transferred to the spouse.

	Spouse is not a United States citizen $
Employee's estate	
1. Family home	300 000
2. Retirement benefits	300 000
3. Insurance	0
4. Other property	0
Gross estate	600 000
Marital deduction	N/A
Taxable estate	600 000
Estate tax liability	0
Surviving spouse's projected estate	
1. Family home	300 000
2. Retirement benefits	0
3. Insurance property	100 000
4. Other property	300 000
Total	700 000
Projected estate tax liability	37 000

Example 4

IMPLEMENTATION OF COMPREHENSIVE FAMILY ESTATE PLAN

Assumptions

Same as example 1 except that a comprehensive estate plan has been implemented, which includes assigning ownership of the life insurance policy to the spouse, terminating joint ownership of investment property and creating a qualified domestic trust to hold title to the family home.

	Spouse is not a United States citizen $
Employee's estate	
1. Family home	300 000
2. Retirement benefits	300 000
3. Insurance	0
4. Other property	0
Gross estate	600 000
Marital deduction	N/A
Qualified domestic trust	(300 000)
Taxable estate	300 000
Estate tax liability	0
Surviving spouse's projected estate	
1. Family home	N/A
2. Retirement benefits	N/A
3. Insurance proceeds	100 000
4. Other property	300 000
Gross estate	400 000
Projected estate tax liability	0

Exhibit I

UNITED STATES ESTATE TAX RATES APPLICABLE TO ESTATES OF UNITED STATES CITIZENS AND UNITED STATES RESIDENTS

Value of assets in the estate $	United States estate tax rate %
0-600 000	-0-
600 000-750 000	37
750 000-1 000 000	39
1 000 000-1 250 000	41
1 500 000-2 000 000	45
2 000 000-2 500 000	49
2 500 000-3 000 000	53
3 000 000+	55

Exhibit II

UNITED STATES ESTATE TAX RATES APPLICABLE TO ESTATES OF NON-RESIDENTS

Value of assets and estate $	Date of death prior to 11/11/88 %	Date of death after 10/11/88 %
0-60 000	6	0
60 000-500 000	12	35 a/
500 000-1 000 000	18	37 a/
1 000 000-2 000 000	24	43 a/
2 000 000+	30	50 a/

a/ The actual tax rate schedule is much more complex. Amounts have been rounded to facilitate comparison with the prior rate structure.